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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 627

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WILLIAM FLACCUS OAK LEATHER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 8) is unreported. The opinion of the Circuit Court of Appeals (R. 19) is reported in 114 F. (2d) 783.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 13, 1940. (R. 22.) The petition for a writ of certiorari was filed December 13, 1940, and was granted February 10, 1941. The

jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer received insurance payments on account of property which had been destroyed by fire. The question presented is whether the resulting profit is ordinary income or capital gain. The answer to this question depends upon whether the destruction of and payment for the property constituted a "sale or exchange" within the meaning of Section 117 (d) of the Revenue Act of 1934.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 22–31.

STATEMENT

The pertinent facts, found by the Board of Tax Appeals (R. 8) to be as stipulated (R. 14–16), may be summarized as follows:

On or about September 25, 1935, a plant owned by the taxpayer at Buckhannon, West Virginia, was destroyed by fire. The buildings, machinery, equipment, and merchandise were all destroyed. During the taxable year 1935, the taxpayer received, as insurance compensation for its loss, the amount of $174,898, of which $101,765.50 was for merchandise and inventory destroyed and $73,-

132.50 for the buildings, machinery, and equipment. Prior to the taxable year 1935, the buildings, machinery, and equipment had been completely depreciated on the books and records of the taxpayer for income-tax purposes. (R. 8.)

At no time during the taxable year 1935, nor at any time thereafter, did the taxpayer set up a replacement fund or expend any of the insurance proceeds so received in the acquisition of other property similar or related in services or use to the property destroyed or in the acquisition of control of a corporation owning such other property. (R. 8.)

The taxpayer returned the $73,132.50 insurance proceeds as a capital gain for the year 1935. It reported other capital gain, on sales of securities, in the amount of $862.50, which is not here in issue, and capital losses in the amount of $76,767.62, likewise not in issue. Against its total capital loss reported of $76,767.62, it offset its total capital gain reported in the amount of $73,995, and thus reflected on its return a net capital loss of $2,772.62, of which it claimed $2,000 as allowable under Section 117 of the Revenue Act of 1934. (R. 8–9.)

The Commissioner eliminated from capital gain the amounts received by way of insurance on the ground that these amounts were ordinary income. He thus found the capital loss to be $75,967.62,[1] of which $2,000 was allowed as a deduction, under the limitation provided by Section 117 (d) of t. e Rev-

[1] See footnote on p. 4.

enue Act of 1934, and increased the capital loss exclusion from $772.62 to $73,967.62[1] or an increased disallowance of capital loss in the amount of $73,195.[1] The Commissioner then added the $73,132.50 received by way of insurance to ordinary income. (R. 9.)

The Board of Tax Appeals approved the determination of the Commissioner. (R. 8–12.) On appeal to the Circuit Court of Appeals for the Third Circuit the Board's decision was reversed. (R. 19–22.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the gain arising from insurance payments for loss by fire of certain property, owned by the taxpayer, is a gain from the "sale or exchange" of a capital asset which may enter into the computation, under Section 117 (d) of the Revenue Act of 1934, of the deduction allowable for losses sustained by the taxpayer from sales or exchanges of other capital assets.

2. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The taxpayer seeks to offset against losses sustained by it in the taxable year from the sale of

[1] There is apparently an error of $62.50 in these figures, which, however, does not affect the deficiencies determined by the Board.

capital assets the amount of gain which it derived from the payment by an insurance company for property destroyed by fire. The sole question presented is whether there was a "sale or exchange" of the destroyed property within the meaning of Section 117 (d) of the Revenue Act of 1934.

The words "sale" and "exchange," as used in Section 117 (d), are to be taken in their ordinary meaning, and they do not include indemnification received from an insurance company for loss of property. One does not sell or exchange that which has ceased to exist.

There is no merit to the argument that Congress has in Section 112 (f) of the Revenue Act of 1934 classified destruction of property as a sale or exchange, where, as here, the proceeds of insurance are not expended in the acquisition of similar property, nor is there any basis for an argument that there has been an administrative classification to that effect which has received the implied approval of Congress.

ARGUMENT

THE GAIN DERIVED BY THE TAXPAYER FROM THE PAYMENT BY THE INSURANCE COMPANY FOR THE DESTRUCTION OF CERTAIN PROPERTY BY FIRE WAS NOT A GAIN FROM THE "SALE OR EXCHANGE" OF SUCH PROPERTY

During the taxable year 1935, the taxpayer had losses from the sale of capital assets [2] in the amount

[2] The term "capital assets" means property held by the taxpayer, whether or not connected with his trade or business, with certain exceptions not applicable here. See Section 117 (b), Revenue Act of 1934, *infra*, p. 26.

of $76,767.62. Under Section 117 (d) of the Revenue Act of 1934, c. 277, 48 Stat. 680, *infra*, p. 27, these losses are deductible only to the extent of $2,000, plus the gains from "sales or exchanges" of capital assets.

In September, 1935, certain buildings, machinery, and equipment owned by the taxpayer were destroyed by fire, and the taxpayer received insurance in compensation for its loss of $73,132.50. Prior to the taxable year 1935, these buildings, machinery, and equipment had been completely depreciated on the books and records of the taxpayer for income-tax purposes, and consequently the entire amount of $73,132.50 constituted a profit or gain for tax purposes. The taxpayer contends that this gain was a gain from the "sale or exchange" of capital assets, and hence may be added to the specific deduction of $2,000 provided for in Section 117 (d) of the Revenue Act of 1934 in determining the deductible portion of the capital losses sustained by it in the taxable year.

The Board of Tax Appeals, following its decision in *Herder* v. *Commissioner*, 36 B. T. A. 934, affirmed on this point, 106 F. (2d) 153 (App. D. C.), certiorari denied, 308 U. S. 617, rehearing denied, 308 U. S. 639, sustained the ruling of the Commissioner that the compensation received by the taxpayer from the insurance company for the property destroyed by fire did not arise from the "sale or exchange" of the property. The court below

reversed this holding. The sole question here presented is whether there was "a sale or exchange" of the destroyed property within the meaning of Section 117 (d) of the Revenue Act of 1934.

The taxpayer conceded below and the Circuit Court of Appeals held that a realization of loss or gain by the receipt of insurance after the destruction of property is not a "sale" or "exchange" of the property in the usual sense of those words. This holding is clearly correct. A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent. *Five Per Cent. Cases,* 110 U. S. 471, 478. Thus numerous transactions have been held not to be within the meaning of the words "sale or exchange" as used in the revenue acts where they were not within the ordinary meaning of those words; for example, the redemption of bonds before maturity by the issuing corporation (*Fairbanks* v. *United States,* 306 U. S. 436; *Felin* v. *Kyle,* 102 F. (2d) 349 (C. C. A. 3d)); surrender of life insurance and annuity contracts (*Bodine* v. *Commissioner,* 103 F. (2d) 982 (C. C. A. 3d)) compromise of promissory notes (*Hale* v. *Helvering,* 85 F. (2d) 819 (App. D. C.)); oil and gas leases considered as sales under local law (*Burnet* v. *Harmel,* 287 U. S. 103). An exchange is the transfer of property for property. A payment on a fire insurance policy, on the other hand, is idemnification for the loss of the property. See *Herder* v. *Commissioner, supra; Commonwealth* v. *Wetherbee,* 105 Mass. 149, 160; *Dover Glass Wks. Co.* v.

Amer. Fire Ins. Co., 1 Marv. (Del.) 32, 45; *Brock* v. *Hardie*, 114 Fla. 670, 686; *Atlantic Steel Co.* v. *Hartford Fire Insurance Co.*, 39 Ga. App. 680.

The sole contention advanced below by the taxpayer was that Congress, in Section 112 of the Revenue Act of 1934, *infra*, p. 23, had classified, for tax purposes, the involuntary conversion of property by destruction and other named involuntary methods as a sale or exchange of the property. This contention was sustained by the court below.

Section 112 does not deal in any way with the *classification* of gain or loss; it does not undertake to say what shall be treated as capital gain or loss and what shall be treated as ordinary gain or loss. Section 112 is concerned with the *recognition* and *non-recognition* of gain or loss in corporate reorganizations and similar transactions; it provides the extent to which gain that would otherwise be taxable is to be entirely relieved of tax, and the extent to which an otherwise deductible loss is to be denied. Subdivision (a) of Section 112 states as the general rule that upon the "sale or exchange" of property the entire amount of gain or loss, determined under Section 111, shall be recognized "except as hereinafter provided in this section". There then follow a number of subdivisions dealing with corporate reorganizations and other transactions of somewhat comparable character. Among

those subdivisions is subdivision (f), which reads as follows:

> *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

It will be noted that Section 112 (f) deals with the *replacement* of property by other similar property. In such cases only the form of the investment is changed, and Congress was therefore willing to include the transaction described in Section 112 (f) in a single class with others in the remaining subdivisions of Section 112 which had the same general characteristic of change of form without change of substance. But here the prop-

erty destroyed was not replaced, and we therefore think that Section 112 (f) has no application whatever.

It is true that Section 112 (f) deals in the last sentence with "any part of the money" which is not expended for replacement. But that is clearly intended to insure that a transaction otherwise within Section 112 (f) shall not be affected by a failure to expend for replacement every dollar of the money realized. Section 112 as a whole deals with situations where property is exchanged for similar property and, unless Section 112 (f) is an exception, it does not purport to deal with dispositions of property solely for cash. Cf. *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462.

We submit that the last sentence of Section 112 (f) is applicable only where there has been a replacement in which all of the money realized was not expended. Although Congress was primarily interested in replacement, it realized that the taxpayer might receive cash and make his own replacement, and that there might be an unexpended balance of cash remaining after the replacement was made. Rather than limit the tax benefit to a transaction where the insurance company made the replacement, Congress included as well the transactions where the taxpayer collected the insurance money and made his own replacement, and rather than insist upon a replacement which would cost the identical amount realized, Congress in-

cluded the case where there was an incidental unexpended balance. To insure that these situations be covered, the last sentence was added to the section, but it was never intended, we submit, to deal with the situation where the taxpayer retained the insurance money and made no replacement. It would be pointless for Congress to require that the replacement must consist of property "similar or related in service or use", but nevertheless make the section applicable to a transaction in which there has been no replacement whatever.

If we are correct that Congress was concerned in Section 112 (f) with the *replacement* of property and not, as contended by taxpayer (Br. in Op. 3), with the "destruction of property, and its compensation", then Section 112 (f) has no application whatever to this case and taxpayer's contention that Congress made an exception applicable to this transaction necessarily fails.

However, if Section 112 (f) is applicable to a mere destruction of property and compensation therefor, the conclusion of the court below is nevertheless erroneous.

The conclusion of the court below that Congress had classified involuntary conversions of property as a sale or exchange of the property was based upon the fact that Congress had placed the provision relating to involuntary conversions in Section 112 as an exception to the general rule set forth in subdivision (a) of that section with re-

spect to a sale or exchange. The court below also stated that its conclusion was fortified by the fact that in Section 111 (a) and (b) Congress speaks of the gain from the sale or other disposition of property, whereas in Section 111 (c), in providing that Section 112 should govern the recognition of gain or loss, it speaks of a sale or exchange.[3] We submit that the decision of the court below is erroneous.

First. It will be observed that the question in the present case is the converse of that in *Helvering* v. *Hammel*, No. 49, present Term, decided January 6, 1941. In the *Hammel* case the question was whether a forced sale, which would be within the ordinary meaning of the word "sale", should be excluded from the meaning of the word as used in the revenue act because of the purpose with which the word was used in the statute and the legislative history of that use. Here the question is whether Congress has declared that a transaction which is

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[3] We believe that no importance should be attached to Section 111 (c). The provision contained in that subdivision first appeared in subdivision (d) of Section 202 of the Revenue Act of 1924. In S. Rep. No. 398, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 266, 275), the Committee on Finance stated:

> Subdivision (d) is merely informatory, stating that the amount of the gain determined under its provisions shall be recognized as provided in section 203, which states those cases in which no gain or loss from a sale or exchange is recognized and those cases in which a limitation is placed upon the gain or loss to be recognized from the sale or exchange.

not within the ordinary meaning of sale or exchange should be treated as though it were a sale or exchange.

There admittedly is no express provision in either Section 112 or elsewhere in the revenue act that an involuntary conversion of property shall be treated as a sale or exchange of that property. It would seem clear that if Congress had intended that loss of property by fire or other casualty, which would not be considered a sale or exchange of property within the ordinary meaning of those words, should be treated as a sale or exchange, it would have declared its purpose in apt language. In all other instances where it has intended that a transaction which would not be embraced within the ordinary or usual meaning of the words sale or exchange should be treated as though it were a sale or exchange, Congress has been specific in so stating. Thus, in Section 115 (c) of the Revenue Act of 1934, it is provided that amounts distributed in complete liquidation of a corporation "shall be treated" as in full payment "in exchange for" the stock. In Section 117 (e) (1) of the Revenue Act of 1934 it is provided that gains or losses from short sales of property "shall be considered" as gains or losses from "sales or exchanges of capital assets". In Section 117 (e) (2) it is provided that gains or losses attributable to the failure to exercise privileges or options to buy or sell property "shall be considered" as gains or losses from "sales or ex-

changes of capital assets". In Section 117 (f) it is provided that amounts received by the holder upon the retirement of bonds and other evidences of indebtedness issued by any corporation with interest coupons or in registered form "shall be considered" as amounts received "in exchange" therefor. And in Section 23 (k) (2) of the Revenue Act of 1938 c. 289, 52 Stat. 447, it is provided that if any securities as defined in paragraph 3 of that subsection are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, "be considered" as a loss from the "sale or exchange", on the last day of such taxable year, of capital assets.

Second. Subdivision (f) of Section 112 of the Revenue Act of 1934 is the outgrowth of provisions which first appeared as Sections 214 (a) (12) and 234 (a) (14) of the Revenue Act of 1921. Sections 214 (a) (12) and 234 (a) (14) contain identical language, the former of these two sections appearing under the heading "Deductions Allowed Individuals", and the latter appearing under the heading "Deductions Allowed Corporations". These sections provided that if property is compulsorily or involuntarily converted into cash or its equivalent as a result, *inter alia*, of its destruction in whole or in part, and if the taxpayer proceeds forthwith in good faith, under reg-

ulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds.[4]

In the Revenue Act of 1921, under the heading of "Basis for Determining Gain or Loss", there appeared in subdivision (c) of Section 202 provisions dealing with the non-recognition of a gain or loss upon certain exchanges of property. In subdivision (d) (1) of that section it was provided that where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of that section, be treated as taking the place of the property exchanged therefor, with certain exceptions which were set forth in subdivision (e) of that section. Subdivision (d) (2) of Section 202 of the Revenue Act of

[4] See H. Rep. No. 350, 67th Cong., 1st Sess., p. 12 (1939–1 Cum. Bull. (Part 2) 168, 177); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 181, 191).

1921 contained a provision with respect to the involuntary conversion of property, as follows:

> Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted.

In the Revenue Act of 1924, the provisions of the preceding Act of 1921 relating to the recognition of gain or loss were placed in a separate section (Section 203). There was included in that section under subdivision (b) (5) a provision with relation to the involuntary conversion of property which in effect constituted a combination and revision of Sections 214 (a) (12) and 234 (a) (14) of the 1921 Act.[5] This provision, contained in Section 203 (b) (5) of the Revenue Act of 1924, was carried forward in identical language in later revenue acts and appears as subdivision (f) of Section 112 of the Revenue Act of 1934.

It is thus seen that the predecessor section to

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[5] See H. Rep. No. 179, 68th Cong., 1st Sess., pp. 13–14 (1939–1 Cum. Bull. (Part 2) 241, 251); S. Rep. No. 398, 68th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 266, 276).

subdivision (f) of Section 112 of the Revenue Act of 1934 took the form of a deduction from gross income under specially stated circumstances, namely, where gain was derived from the involuntary conversion of the property and the proceeds of the conversion were forthwith expended for the acquisition of other property of a similar character or in the establishment of a replacement fund. Where there was such an acquisition of similar property with the proceeds of an involuntary conversion, the newly acquired property was considered as taking the place of the old property. In these special circumstances, Congress has disregarded the receipt and expenditure of cash and has treated the transaction as though the old property were exchanged directly for the new property. In the revision and rearrangement of the statutory provisions which occurred in the Revenue Act of 1924, Congress changed the provision from the form of a deduction to one of non-recognition of gain or loss upon the transaction. Since the new statutory provision was cast in the form of non-recognition of gain or loss it was logical that it should appear in a section dealing generally with non-recognition of gain or loss. It is true that the provisions dealing with non-recognition of gain or loss are expressed as exceptions to the general rule that the entire amount of gain shall be recognized upon the sale or exchange of property. It will be noted, however, that there is no exception to the

recognition of gain or loss upon a pure sale, that is, where property is transferred for cash or its equivalent. Cf. *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462.

The only exceptions to the recognition of gain or loss are cases where there has been a transfer of property for property. As pointed out, Congress has treated the conversion of property by fire and other involuntary methods as a transfer of property for property, i. e., an exchange, only where the cash received upon the involuntary conversion is forthwith used for the acquisition of other property similar or related in service or use to the property so converted. There is, we submit, in these statutory provisions, no indication of a congressional purpose to treat the destruction of property as a sale or exchange of that property where cash only is received and where this cash is not expended in the manner specified in the statute. Cf. *Bandes* v. *Commissioner,* 69 F. (2d) 812 (C. C. A. 2d), involving the condemnation of property, which embraces features of a sale not present in the case of destruction of property and therefore conceivably to be governed by a different rule. In the present case the taxpayer received only cash indemnification for its loss by fire and it concededly did not expend this cash for the acquisition of other property similar to the destroyed property or in the establishment of a replacement fund. Admittedly, therefore, the taxpayer is not entitled to the benefits of subdivision (f) of Section 112.

Third. In none of the Treasury Regulations promulgated under the revenue acts prior to that of 1934 has there been a classification of the gain arising from the payment for destruction of property by fire or other casualty as a gain arising from the sale or exchange of a capital asset. See Article 1600, Treasury Regulations 65 and 69; Article 601, Treasury Regulations 74 and 77. In Article 113 (a) (9) (1) of Treasury Regulations 86, promulgated under the Revenue Act of 1934, *infra*, p. 30, which deals with the basis of property acquired with the proceeds of insurance from destroyed property, there appeared for the first time the statement that "As to the amount of such gain to be taken into account in computing net income, see section 117". Section 117 is the section relating to capital gains and losses. Treasury Regulations 86 were approved on February 11, 1935. On September 23, 1936, the language which we have quoted from Article 113 (a) (9) (1) was eliminated. See T. D. 4698, XV-2 Cum. Bull. 159 (1936). There appears, therefore, to have been no consistent administrative practice classifying the destruction of property as a sale or exchange of property.

It is clear that destruction of property by fire is not a "sale or exchange" of property within the ordinary meaning of those words, and, we submit, there is no congressional classification, express or implied, of such destruction as a sale or exchange.

CONCLUSION

The decision of the court below is erroneous and should be reversed.

Respectfully submitted.

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MARCH 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23. [U. S. C., Title 26, Sec. 21.]

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

* * * * *

(e) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. [U. S. C., Title 26, Sec. 22.]

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * *

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the

time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

(f) LOSSES BY CORPORATIONS.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(j) CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

* * * * *

[U. S. C., Title 26, Sec. 23.]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

[U. S. C., Title 26, Sec. 111.]

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property Held for Productive Use or Investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(2) *Stock for Stock of Same Corporation.*— * * *

(3) *Stock for Stock on Reorganization.*— * * *

(4) *Same—Gain of Corporation.*— * * *

(5) *Transfer to Corporation Controlled by Transferor.*— * * *

(c) *Gain From Exchanges Not Solely in Kind.*—

* * * * *

(d) *Same—Gain of Corporation.*—

* * * * *

(e) *Loss From Exchanges Not Solely in Kind.*— * * *

(f) *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Com-

missioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

* * * * *

[U. S. C., Title 26, Sec. 112.]

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

* * * * *

(6) TAX-FREE EXCHANGES GENERALLY.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received,

and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * * * *

(9) INVOLUNTARY CONVERSIONS. If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in section 112 (f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

* * * * *

[U. S. C., Title 26, Sec. 113.]

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income: * * *

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade

or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(c) DETERMINATION OF PERIOD FOR WHICH HELD.—* * *

(d) LIMITATION ON CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(e). GAINS AND LOSSES FROM SHORT SALES, ETC.— * * *

(f) RETIREMENT OF BONDS, ETC.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a gov-

ernment or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. [U. S. C., Title 26, Sec. 101.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 112 (f)-1. *Reinvestment of proceeds of involuntary conversion.*—In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

* * * * *

It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

ART. 112 (f)-2. *Replacement funds.*—In any case where the taxpayer elects to replace

or restore the converted property but it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See section 1126 of the Revenue Act of 1926 (paragraph 31 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and

the surety or depasitory may each have a copy.

ART. 113 (a) (9)–1. *Property acquired as a result of an involuntary conversion.*—The provisions of section 113 (a) (9) may be illustrated by the following example:

Example: A vessel purchased by A in 1926 for $100,000 is destroyed in 1934 and A receives insurance in the amount of $200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000).

ART. 117–1. *Meaning of capital assets.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117–2. *Limitations on capital gains and capital losses.*—* * *

Section 117 (d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. However, in the case of certain banks or trust companies, this

limitation is subject to the modification provided in that section.

* * * * * *

ART. 117–4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)–3), or loss sustained as the result of corporate stock or debts becoming worthless.

U. S. GOVERNMENT PRINTING OFFICE: 1941

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